

Effective Date: September 8, 1996

**COORDINATED ISSUE
MINING INDUSTRY
TRANSITIONAL PROPERTY**

ISSUE:

Whether the specifications and amount of mining property are readily ascertainable from the terms of a long term coal supply contract or related documents as of December 31, 1985, so that the mining property can qualify for the investment tax credit and the Accelerated Cost Recovery System ("ACRS") under the supply or service contract transition rule of § 204(a)(3) of the Tax Reform Act of 1986?

FACTS:

Due to the enormous amount of capital required to mine and produce coal, it is common practice in the coal industry to sell coal through long term supply contracts. These contracts typically obligate the coal producer to sell coal and the buyer, normally a public utility, to purchase the coal at an agreed price for a fixed period of time, which can vary from several years to several decades. The price of the coal is usually based upon a pricing formula, which may allow adjustment for various factors, including the replacement cost of assets. The contracts can specify the quantity of coal to be delivered on a monthly and/or yearly basis. The source and quality of the coal to be delivered are usually spelled out in the supply contract. For example, a contract may require that the producer supply coal from mines it owns within a certain geographic region. Another common provision found in these supply contracts requires that the coal producer operate in compliance with all state and federal government regulations.

In connection with their long-term supply contracts in existence prior to 1986, some coal producers have taken the position that they may be entitled to relief under the transitional rule of § 204(a)(3) of the Tax Reform Act of 1986 and can claim investment tax credit (on property placed in service after 1985) and utilize ACRS (on property placed in service after 1986) with respect to property acquired to fulfill these supply contracts.

CONCLUSION:

In order to claim investment tax credit and ACRS depreciation for equipment acquired to extract coal sold pursuant to a long term supply contract, the coal producer must establish that the equipment is specifically required by the long term supply contract or

related documents to be obtained by the coal producer. If the coal producer is unable to establish that the specifications and amount of the acquired mining equipment are set forth in the long term coal supply contract or related documents, the coal producer will not be entitled to investment tax credit and ACRS depreciation deductions under the supply and service contract transition rule of § 204(a)(3) of the Tax Reform Act of 1986

DISCUSSION:

Former section 49(a) of the Code, as added by section 211(a) of the Tax Reform Act of 1986, provides that the 10 percent regular investment credit does not apply to property placed in service after December 31, 1985. Former section 49(b)(1) provides that the repeal does not apply to "transition property" as defined in former section 49(e), subject to the general limitations in former sections 49(c) and (d).

Former section 49(e)(1) of the Code defines the term "transition property" as any property placed in service after December 31, 1985, and to which the amendment made by section 201 of the Tax Reform Act of 1986 does not apply, except that in making the determination, section 203(a)(1)(A) of the Act shall be applied by substituting "1985" for "1986," and sections 203(b)(1) and 204(a)(3) of the Act shall be applied by substituting "December 31, 1985" for "March 1, 1986." In addition, certain placed in service dates apply depending upon the class life of the transition property.

Section 203(b)(1)(A) provides the general transitional rule, commonly referred to as the "binding contract" rule. According to this rule, investment credit transition relief is afforded to any property that is constructed, reconstructed, or acquired by the taxpayer pursuant to a binding contract that was binding on December 31, 1985, provided the relevant property is the subject matter of the contract. H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II-54 (1986) (hereinafter "Conf. Rep."). In addition, to be deemed binding, a contract must be enforceable under state law, not limit damages to a specified amount, and not have been substantially modified after the date the contract went into effect. Conf. Rep. at II-55.

Section 204(a)(3) of the Act provides an additional transitional rule, which is the focus of this paper, for property that is readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease, that was binding on December 31, 1985. The conference report in explaining this provision states, in part, that:

[t]he bill provides transitional relief for certain situations where written binding contracts require the construction or acquisition of property, but the contract is not between the person who will own the property and the

person who will construct or supply the property. This rule applies to written service or supply contracts and agreements to lease entered into before March 2, 1986, (January 1, 1986, in the case of the investment tax credit)...

This transition rule is applicable only where the specifications and amount of the property are readily ascertainable from the terms of the contract, or from related documents. A supply or service contract or agreement to lease must satisfy the requirements of a binding contract (discussed above). [Conf. Rep. at II 59–60]. (Emphasis added).

Based on the foregoing statutory language and legislative history, the transition rule will not apply with respect to property placed in service by a taxpayer after December 31, 1985, pursuant to the supply contract, unless the specifications and amount of such property are readily ascertainable from the terms of the contract or related documents.

A document will be considered related to the contract only if it specifically relates to, or can be readily identified with the supply contract in question. The documents must be contemporaneous with and part and parcel of or supplementary to the related supply contract and must be in existence prior to 1986. In addition, the documents must describe the equipment needed to meet the contract requirements.

Some coal producers have argued that all mining equipment acquired and used in connection with a coal supply agreement in existence prior to December 31, 1985, should automatically qualify under § 204(a)(3) of the Act. They point to a colloquy between Senators Long, Packwood, and Matsunaga, prior to final passage of the bill, in which the bill managers Long and Packwood, indicated that Matsunaga was correct in his understanding that:

the requirement [that the property be readily identifiable with and necessary to carry out the contract] is met when a binding power purchase contract specifies the type of generating equipment in terms of primary energy source and specifies the amount of generating capacity of the turbines necessary to produce the contracted power. In other words, the rule does not require the technical details of the generating property be spelled out.

32 Cong. Rec. § 8241 (1986).

Taxpayers have argued that the above colloquy indicates that a coal supply contract meets the specification requirements of § 204(a)(3), as long as the contract specifies the primary energy source (coal of a stated quality) and the total energy capacity (total

coal tonnage over the life of the contract). Since coal supply contracts normally contain provisions providing for the quality and amount of coal to be delivered, the taxpayers contend that coal supply contracts will satisfy the specification requirements and that the particular equipment necessary to fulfill these contractual obligations would be readily apparent to a person knowledgeable of the industry, its methods of production, the geology of the coal reserves in a particular region and the economic constraints involved.

The colloquy does not support that position, however, because Senator Matsunaga's inquiry was with respect to a contract that specified both the type of generating equipment in terms of primary energy source and the amount of generating equipment in terms of total generating capacity of the turbines necessary to produce the contracted power. Although it may not be necessary for the contract to set forth all of the technical details of the property to receive the credit, the contract must at least, effectively specify the type and amount of such property.

Moreover, the required specificity for property required to carry out a supply contract can not be inferred solely from the minerals to be mined and sold under the contract. For example, although it may be obvious to a mining engineer that a certain steam shovel is necessary to carry out a coal supply contract for 500 tons of coal, it will not receive a credit unless the amount and type of property is identified with sufficient specificity in the contract or related documents. To grant the credit to any property that can be inferred to be necessary to complete such contract would render the specificity requirement meaningless.

The degree of specificity required by a coal supply contract was addressed by the district court in United States v. Zeigler Holding Co., 77 AFTR 2d ¶96-515 (S.D. Ill. 1996). The court denied the government's motion for summary judgment on the grounds that the government had failed to carry its burden of proof with respect to all of the property claimed to be eligible for the investment tax credit, since certain property claimed by taxpayer was referenced in taxpayer's supply contract. However, the court acknowledged:

that to allow a supply contract to implicitly require the acquisition of property, means that the transition rule exception would swallow the rule eliminating the ITC. As a result, the Court agrees with [the government] that in order to be eligible for the ITC, the property must be specifically described [in the coal supply contract].

77 AFTR 2d ¶96-515 at 96-1061.

In addition, the fact that a taxpayer may need to purchase additional equipment or replace worn-out equipment in connection with a pre-1986 supply contract as part of its

normal business operation will not be enough to allow transitional treatment on all equipment purchases through 1990. Transitional relief is not available simply because an industry expert could predict or foresee the need for such purchases.

EXAMINATION POSITION:

For purposes of the transition rule under § 204(a)(3) of the 1986 Act, property necessary to carry out a coal supply contract is "readily identifiable" with the supply contract only if the specifications and amount of the property are readily ascertainable from the contract itself or related documents. Although not all of the technical details of such equipment need be disclosed, the supply contract must disclose the specifications and amount of the property necessary to carry out the contract to a degree sufficient to readily identify such property with the contract. This requirement is not met by a contractual provision that provides that the coal producer will purchase at its cost all equipment necessary to carry out the contract, or one which sets forth a pricing formula providing an adjustment in the coal price for depreciation and replacement of property.